TENNESSEE REGULATORY AUTHORITY

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March 22, 2002

David P. Boergers
Secretary
Federal Energy Regulatory Commission
888 First St., N.E.
Washington, DC 20426

Re: Docket Nos. RT01-67-000, RT01-67-001, RT01-67-002, RT01-74-003, RT01-74-004, RT01-74-005, RT01-75-000, RT01-75-001, RT01-77-002, and RT01-100-000

Dear Secretary Boergers,

On January 2, 2002, the Commission sent a letter to the Tennessee Regulatory Authority (TRA) seeking comments on questions regarding RTO formation in the Southeast. The TRA would like to thank the Commission for considering the views of states in this undertaking. The TRA appreciates the Commission's interest in its comments on a Southeast regional transmission organization.

Tennessee is part of the Southeastern Electric Reliability Council (SERC). The only investor-owned electric utility regulated by the TRA is Kingsport Power Company, part of the American Electric Power (AEP) system, located in Tennessee adjacent to its border with Virginia. The AEP system is one of several that will constitute a major portion of any Midwest transmission organization. Kingsport, however, is a distribution company that obtains wholesale power through the AEP system over transmission lines that enter Tennessee from Virginia. These transmission facilities are in the federal jurisdiction and the rates Kingsport has paid for wholesale power have been set by the Commission. As Kingsport Power serves relatively few Tennessee customers, Tennessee regulators historically have had little involvement in transmission issues.

Moreover, even though Kingsport is the largest investor-owned electric utility regulated by the TRA, the vast majority of electric power delivered to consumers in the state is generated and transmitted by the Tennessee Valley Authority (TVA) to municipal

or cooperative distributors. Most of the electric industry in Tennessee consists of federal or local government entities or customer-owned cooperatives, none of which are under TRA jurisdiction. This has separated the TRA even further from transmission issues in the past.

The TRA believes that any Southeast RTO should encourage the participation of or coordination with non-jurisdictional public power entities. Otherwise, the Southeast RTO will not address adequately the needs of the region. Although the TRA has not had much previous involvement in electric regulation and especially in electric transmission issues, the TRA offers its responses below based on general concepts concerning RTOs and a few pertinent details which may be unique to Tennessee.

1. **What RTO structure – a single RTO, multiple RTOs with seams agreements, or other – would most efficiently administer the transmission system and facilitate electric power trading to meet the needs of customers over the Southeast?**

Response:

Although the Commission declined to establish regional boundaries, it stated that the regional configuration of a proposed RTO should be large in scope. Order No. 2000 states that an RTO must serve a region of sufficient scope and configuration to permit the RTO to effectively perform its required functions and to support efficient and nondiscriminatory power markets. (Order No. 2000, slip op. at 238, 254). The Commission supports the development of one RTO for the Southeast. (Order on Compliance Filing and Status Report, Docket Nos. RT01-74-002 and RT01-74-003; July 12, 2001 –"Status Report Order")

Concerning non-jurisdictional electric utilities, Order No. 2000 states that "a properly formed RTO should include all transmission owners in a specific region, including municipals, cooperatives, federal Power Marketing Agencies (PMAs), Tennessee Valley Authority and other state and local entities. Public power and cooperative participation in RTOs will enhance the reliability and economic benefits of an RTO. Furthermore, participation by public power entities and cooperatives is vital to ensure that each RTO is appropriate in size and scope." Order No. 2000, slip op. at 589.

In the Southeast region, a large portion of the transmission grid is owned by electric utilities that are not subject to state or federal jurisdiction. These include federal utilities (e.g., Tennessee Valley Authority), electric cooperatives, municipal utilities, and state agencies. Any RTO in the Southeast must gain the participation of such electric utilities in order to meet the scope and regional configuration characteristic of Order No. 2000.

The Commission already approved the formation of RTOs in the Southeast: GridFlorida LLC (See Docket Nos. RT01-67-000 and RT01-67-001) and GridSouth Transco, LLC (See Docket Nos. RT01-74-002 and RT01-74-003). In addition, the

Commission is in the review and mediation process for a Southeast Power Grid RTO sponsored by the SeTrans Sponsors (See Docket Nos. RT01-77-00 and RT01-100-000). If these three RTOs were to receive final approval by the Commission, only the TVA and Entergy transmission systems would remain uncovered by an RTO. This will leave holes in the region that will lead to more problems, specifically "seams" issues, congestion management and pricing issues, market monitoring issues, cost shifting problems, pancaked transmission rates, transmission planning conflicts, and regional and interregional coordination issues. The consequent uncertainties created in the market could potentially harm consumers.

A single RTO is likely preferable to multiple RTOs in facilitating a competitive market for electric power generation. Non-discriminatory access to the grid by buyers and sellers may be more easily promoted with one RTO; external loop flows and other "seams" issues may also be minimized, facilitating cost-based rates for transmission. This promotes competition by reducing the complexity of transactions between buyers and sellers and by widening the potential geographic reach of such transactions. The importance of any particular generator or transmission route to the smooth functioning of the RTO may be reduced in proportion to the entire system, spreading and, perhaps, reducing the risk of a system wide failure.

The formation of a single RTO in the Southeast will facilitate the broadest possible energy trading area in which a seamless market can evolve. The TRA believes that any formation of an RTO should be justified by a cost-benefit analysis, however, and should preserve state authority to approve or disapprove the transfer of assets from regulated utilities to the RTO, especially to a Transco. Based on the Commission's recent Economic Assessment of [the Benefits and Costs of] RTO Policy, the TRA finds insufficient evidence to conclude that a single RTO in the Southeast will produce greater benefits than multiple RTOs in the region.

The comments of the TRA on the Commission's RTO Cost-Benefit Report will be filed on or before April 9, 2002 as requested by the Commission. They will include specific findings on issues that affect Tennessee electricity consumers. The TRA wants to emphasize here that with respect to the issue of a single RTO versus multiple RTOs, the Commission's Cost-Benefit Report does not show the regional distribution of costs and benefits for different markets that exist in the Southeast region in a way that allows comparisons of all the costs and benefits of one RTO in contrast to multiple RTOs. For example, the report does not show if it would be beneficial or not for TVA to form an RTO or to affiliate with a single Southeast RTO. Indeed, the Cost-Benefit Report did not include a valuation of costs and benefits accruing to electric utilities in different states, nor did it include specific assumptions regarding the terms of participation by non-jurisdictional utilities.

2. **If you think more than one RTO is appropriate in the Southeast, (a) how should market interface and reliability issues at the seams be resolved and (b) what should be the scope of the RTO that would include the electric utilities in your state?**

Response:

(a) Kingsport Power Company sits on what may be a major seam between a Midwest RTO and a Southeast RTO. Market interface and reliability issues at the seams should be resolved in a manner that balances marketers' needs with those of customers. Some wholesale trades may threaten the reliability of service to customers who do not necessarily benefit from the transaction. When wholesale trading and reliability conflict, seams agreements should favor the objective of reliability, especially given the relatively small cost of transmission in comparison to generation and distribution costs. On the other hand, seams restrictions should not be allowed to isolate certain areas from adequate competing alternative sources of power, undermining both the competitive process and the reliability of supply.

(b) The Southeast region is comprised of the Entergy and SPP region, GridSouth RTO, Grid Florida RTO, SeTrans proposed RTO, and TVA and other non-jurisdictional electric utilities. If these utilities are not market participants in the Southeast RTO, "seams" or pancaked rates will result. The TRA believes that TVA forms a natural market area that should remain within one RTO. If the Commission was to adopt multiple RTOs in the Southeast, the TRA recommends that cost-benefits studies determine the viability of such RTOs; and that said RTOs be linked by effective interregional coordination agreements to internalize externalities. After a brief examination of the Commission's Cost-Benefit Report, the TRA believes that the study presented in the report failed to support such a determination.

3. **(a) Order No. 2000 permits hybrid RTOs. If the functions specified in Order No. 2000 are shared or coordinated between an ISO and an independent transmission company (ITC), how would you suggest that those functions be apportioned? For example, which organization should perform planning and expansion, tariff administration, OASIS administration, market monitoring, security coordination, and interregional coordination? What role do you believe an ITC could or should play in the Southeast?**

Response:

The TRA is concerned that the profit motive for a transmission provider may adversely affect reliability. Nevertheless, this question is difficult to answer in the absence of Commission decisions on threshold issues concerning the degree of independence of transmission providers from generation and distribution interests. Any transmission entity, for-profit or not-for-profit, with substantial interests in another stage of the electric industry may have incentives to favor that stage in making transmission decisions, rather than making decisions in a manner that serves the broader public good.

Absent decisions on these threshold structural issues, only very general statements can be offered. Not-for-profit organizations, for example, which have balanced input from all stakeholders (generators, marketers, distributors, and customers) may best maintain reliability, but at the potential expense of higher costs due to the lack of a profit incentive. For-profit entities, however, especially in the absence of adequate competition, may discriminate in providing access or scrimp on reliability or expansion expenditures, in order to inflate the gap between prices and costs. To state the obvious, for-profit monopoly transmitters should be avoided.

In some circumstances, the TRA can support the idea of an ITC-within-ISO model as a management principle, but ITCs may be given responsibilities overlapping and sometimes conflicting with the duties of RTOs. RTOs should bear the ultimate responsibility for reliability, congestion management, transmission rates, security coordination, OASIS administration, market monitoring loss responsibility, construction of transmission facilities, and interregional coordination. In order to avoid conflicts of interest, perhaps RTOs should advise the Commission on which responsibilities, like local planning and rate design, may be delegated to ITCs on a case-by-case basis.

In the Southeast, a very large portion of the transmission grid is owned by non-jurisdictional electric utilities that are familiar with "not for profit" structures. Both "not for profit" and "for profit" structures can efficiently manage transmission facilities as long as proper guidelines are put in place to control strategic behavior, improve performance, and ensure financial responsibility. The TRA is concerned, however, that the Commission's Cost-Benefit Report did not explicitly address the possible or likely organizational forms (Transco, ISO, hybrid, or other form) of RTOs.

(b) If an ITC is appropriate for your region, is it necessary for an umbrella independent board to have ultimate responsibility for RTO functions?

Response:

Yes, an ITC should be placed under an umbrella independent board with ultimate responsibility for RTO functions because the RTO has the responsibility of ensuring efficient, reliable operations in its region.

(c) Does an ITC need to provide RTO functions to be a viable business, or can it own and invest in transmission with agreements on revenue requirements with the ISO or RTO umbrella organization?

Response:

An ITC does not need to provide all necessary RTO functions to be a viable business. However, any ITC should be consulted on certain RTO functions like local planning, rate design, impact studies, and interconnection studies under the oversight of the RTO, which will coordinate bulk power and interface planning.

4. **Order No. 2000 recognizes that wholesale electricity markets are becoming increasingly regional in nature and that new trading patterns are putting additional stress on the interstate transmission system. However, many of the functions that RTOs will be called upon to perform clearly have both regional and local implications (e.g., planning and expansion decisions which ultimately require the siting approval of one or more states). Do you have suggestions regarding how states can work with one another, with the RTO, and with the FERC to ensure that needed transmission infrastructure is sited and built in a timely manner? With regard to other RTO functions, are additional processes needed to ensure that states have the ability to fulfill their regulatory responsibilities or to adequately protect retail electricity customers?**

Response:

A forum through which the various states and federal regulators could cooperate to resolve any conflicts would appear beneficial. The TRA is concerned that absent such forum, RTO formation in the Southeast may lead to many adverse effects such as efficiency loss in the transmission system, higher transmission rates, and cost shifting among states' retail customers. The TRA is also concerned that, if states are not actively involved in the process, RTO formation may shift regulatory responsibilities and preempt state regulators of their ability to fulfill their regulatory responsibilities, or to adequately protect retail electricity customers.

5. **What process do you believe would be the most efficient for obtaining the input of state commissions in the Southeast on the issue of RTO formation?**

In Order No. 2000, the Commission concluded that it is in the public interest to provide for a voluntary approach to RTO formation that relies upon encouragement, guidance, and support from the Commission. Order No. 2000, slip op. at 117. The TRA supports Order No. 2000 and believes that it is in the public interest to include inputs of state regulators on the issue of RTO formation. Specifically, a collaborative process and a mediation process (if necessary) are needed to guarantee the participation of state regulators and to achieve a settlement on disputed issues. In addition, the Commission should keep state regulators informed through timely requests for comments and other notices.

6. **Please provide your ideas on ways in which state commissions can have input on RTO decisions.**

Most RTO proposals do not reserve a role to state regulators. The Collaborative Governance Model (CGM) proposes to have a representative of the government or non-profit organizations that are not utilities on the Advisory Committee to represent the end-

use consumers' economic or environmental interests. The SeTrans Model also proposes to have representatives of state governmental agencies/consumer advocates on the Stakeholder Advisory Committee (SAC).

One representative from governmental or non-profit organizations would not adequately represent a state's interests on the SAC. Most states have different agencies with oversight over regulation of public utilities, environmental protection, energy policy and economic development. All of these types of agencies, possibly with different expertise and objectives, may want to be involved in the RTO formation process. Moreover, the interests of non-profit organizations often differ from those of state agencies. These considerations justify the need for more representatives of states' interests on the SAC.

It is imperative that states have a role in overseeing the RTOs, in a role distinct from the SAC. RTOs should comply with all state requirements for planning, expansion and siting of transmission facilities, tariff design, congestion management, interconnection, ancillary services, etc. RTOs (and the Commission) should not preempt state authority over transmission facilities, reviewing transfers of ownership and control of assets owned by electric utilities in the state, retail ratemaking issues, etc. This is particularly important in most Southeast states where restructuring has yet to be approved.

7. **What actions –either procedural or substantive – do you believe the Commission could take to encourage the participation of public power entities in RTO formation in the Southeast?**

The TRA believes that public power entities should participate in RTO formation. The scope and configuration of RTOs will depend on which model attracts participation by all non-jurisdictional electric utilities. In the Southeast, the SeTrans model attracted the most support while the CGM was found by many non-jurisdictional utilities to be biased against them. The Commission should encourage public power entities to actively participate so that their inputs can be included in the RTO formation process.

8. **With regard to the two models proposed in the Commission's mediation hearings, the Collaborative Governance Model (CGM) and Independent System Administrator (ISA) model, which features of each model do you support or not support? In what way might your interests and objectives be preserved under each model?**

Response:

With respect to RTO characteristics:

1. **Independence**

The CGM gives authority to an independent Transco board with authority over all market issues, rate decisions, and tariff design. The SeTrans proposal provides that the

ISA will have all authority except Market Monitoring, will be independent of all market participants, and will not own transmission facilities. The TRA believes that the ISA's authority can be compromised by transmission owners who are members of the SAC, which selects and can terminate the ISA.

2. Scope and Regional Configuration

Because either the CGM or the ISA could be established as a single RTO in the entire Southeast, the scope and configuration will be dependent on which model attracts participation by non-jurisdictional utilities. The CGM appears to have the least support from non-jurisdictional utilities, but the CGM would lead to many holes in the RTO. This would defeat the goals of Order No. 2000. The SeTrans sponsors have secured "seams" agreements with the TVA. If the CGM was adopted for the Southeast without active participation of the TVA in the RTO, "seams" issues, interregional coordination, planning and expansion, tariff design and other RTO functions would greatly suffer.

3. Operational Authority

If markets are sufficiently competitive, the for-profit CGM structure may reduce costs, promote active management of transmission facilities, and improve performance. RTOs are forming before some states implement retail choice, however, so the necessary competition may not exist to guarantee the desired outcome. For example, with a profit motive, a Transco may underinvest and "balkanize" or isolate areas to increase prices to its advantage. Therefore, additional safeguards may be required as competition develops.

The ISA provides a Transco without asset ownership, which may better support balanced scheduling requirements. A Transco without profit motive, however, may lack sufficient financial incentives to constantly improve performance.

4. Short-Term Reliability

Both models are similar, but more details are needed to better understand their differences, if there are any. The TRA believes that only the ISA should have ultimate short-term and long-term control over reliability. In addition, because the RTO will oversee transmission facilities of IOUs and of non-jurisdictional utilities, which may have experienced different levels of reliability, any RTO must clearly provide in the Operating Protocol how reliability issues will be addressed.

With respect to RTO functions:

Tariff Administration and Design

The CGM offers great detail on avoiding cost shifting and rate pancakes. It provides a mechanism to recover the cost of existing facilities, new non-bulk transmission facilities, new bulk transmission facilities, and a charge for grid management. Under this model, a 10-year period will be necessary for the RTO to phase together the regional charges (for the four regions to be created) into a single RTO-wide charge. This model phases in credit for existing facilities of the transmission-dependent utilities (TDUs) over years 1-5 and gives them full credit thereafter. The CGM also offers detailed plans to promote the conversion of existing transmission contracts to the RTO Open Access Transmission Tariff (OATT). The TRA is concerned that by denying TDUs immediate revenue requirement for the first five years, the model alienates the support of these utilities.

The TRA supports the SeTrans compromise of full recovery within 2 years if granting it and eliminating pancaking would not raise the average retail rate by 3% or more. This plan offers more to non-jurisdictional utilities than the plan proposed by the CGM.

Congestion Management

In Order No. 2000, the Commission decided not to prescribe a specific congestion pricing mechanism but affirmed that "markets that are based on locational marginal pricing and financial rights for firm transmission service appear to provide a sound framework for efficient congestion management." Order No. 2000, slip op. at 382.

The CGM proposes a financial rights model and real-time locational marginal pricing to manage transmission congestion. The SeTrans model is a work in progress that combines the flowgate/physical rights model with locational marginal pricing for the flowgate nodes in order to determine the net congestion cost to be allocated to those entities responsible for the congestion.

Because there are many aspects of both models yet to be worked out through the collaborative process, the TRA believes that it is premature to choose either model at this time.

Parallel Path Flow

The CGM affirms that the RTO will be responsible for developing and implementing procedures to address parallel path flow issues, but specific procedures are yet to be developed.

The SeTrans model proposal for congestion management will allow customers causing any external transactions to pay any transmission service charges and congestion costs associated with parallel path flows they impose in order to avoid physical curtailment. The customers imposing a parallel path flow can also purchase firm transaction rights to mitigate exposure to such congestion costs. The SeTrans model is attractive to non-jurisdictional utilities and could achieve a broad Southeast RTO that will internalize parallel path flows within the region.

Ancillary Services

The SeTrans model offers no details on this function. The CGM seems to satisfy the requirements of Order No. 2000. In this model, the RTO will be the provider of last resort for voltage support, regulation, balancing energy, and operating reserves. This model offers bid-based mechanisms and a self-supply option for ancillary services that are consistent with Order No. 2000. The TRA supports the CGM approach but reserves a final decision until future details are provided by the SeTrans sponsors.

OASIS, Total Transmission Capacity (TTC) and Available Transmission Capacity (ATC)

Both the CGM and the ISA model are essentially identical on this function. In both models, the Independent Market Administrator (IMA) and the ISA will be OASIS administrator, and will independently calculate TTC/ATC for the transmission facilities under the RTO's control.

The CGM proposal appears to be more in line with OASIS/TTC/ATC functions in Order No. 2000. However, it is put forward that after five years, the Transco could dismiss the IMA and assume responsibility for these functions. This could compromise the independence of the IMA in exercising these functions.

The SeTrans model proposes a role for transmission owners in determining TTC/ATC which may undermine the independence of the RTO. In addition, the SeTrans model will post TTC and ATC to reflect contract paths based upon the ATC of all the flowgates involved in the contract path, as is the case today. This is not an improvement on industry practices.

The TRA believes that more details are needed on both proposals in order to support either model.

Market Monitoring

Both models are similar in many aspects. In the CGM, the Market Monitor has authority over its budget, subject only to Commission review. The Market Monitor has monitoring authority over both the energy and ancillary services including compliance with market rules by market participants, any ITCs, the IMA and the Transco. In addition, it will review market power and allegations of market abuse, consider and

evaluate enforcement mechanisms that may be necessary to assure compliance with market rules, and prevent or remedy the exercise of market power or other anti-competitive behavior. It will seek Commission approval to remedy such behavior.

The CGM gives the Market Monitor authority to review proposed tariff changes by the Transco and an approval/denial mechanism is provided such that the Commission will be the ultimate approval authority even when the Market Monitor objects to tariff changes.

The independence of the Market Monitor, however, could be compromised by (1) the Transco's role in selecting the Market Monitor, and (2) the non-binding input of the Transco Board and the Advisory Committee in the preparation of the budget of the Market Monitor.

In the Se Trans model, the SAC selects the Market Monitor. The Market Monitor however does not have authority over its budget and has no powers to review any tariff changes by the Transco. Its monitoring authority is reduced in comparison to the Market Monitor in the CGM.

Planning and Design

The CGM proposes that an asset owner will perform the planning function for assets owned by other entities. The Transco may favor its own transmission system over the transmission facilities of other participants or transmission asset owners over non-owning participants.

The SeTrans gives the planning function to the SA, which does not own transmission facilities and should not be biased one way or another, if transmission owners do not participate in selecting the SA.

Interregional Coordination

Both models fail to address this function in detail except for providing some guiding principles for interregional coordination agreements.

9. **Do you think the Collaborative Governance Model or "transco at the top" RTO structure could favor transmissions solutions relative to generation or demand-side solutions to congestion on the grid, and could favor investment in Transco-owned facilities relative to transmission operated but not owned?**

The TRA believes that the Transco owning assets as proposed by the CGM would possibly favor its own assets on issues like transmission expansion, security coordination, revenue allocation, or market design. This model would also favor Transco-owned transmission facilities relative to operated but not owned transmission facilities. The

splitting of RTO functions between the Transco, the IMA and ITCs would aggravate this problem. If the Transco owning assets has too much authority, this would undermine the efficiency of the RTO and create opportunities for competitive advantage and discrimination. Transmission activities are closely linked with generation activities. The CGM is not clear about the financial relationship between the IMA and generators.

10. Do you think that under the ISA model transmission owners' preservation of some control over RTO functions through the System Administrator selection and removal process would affect independence?

Under the ISA model, transmission owners are members of the SAC which selects the ISA or terminates the contract of the ISA. Transmission owners may exercise too much influence over the ISA in this model. Because the ISA's Planning Protocol is not fully developed, the extent of the transmission owners' influence is not clear. Transmission owners should not have more authority than is appropriate under Order No. 2000, which requires decision-making independent of control by any market participant or class of participant. Order No. 2000, slip op. at 194. Thus, the TRA believes that transmission owners should not have a role in selecting or terminating the ISA.

11. Do you have any other suggestions or advice as to how the FERC should proceed in its efforts to complete RTO formation in the Southeast?

Response:

The TRA suggests that the Commission proceed to systematically decide the threshold structural issues for RTOs and other transmission organizations. These include the required degree of independence of transmission providers from other stages of the industry, the general requirements for nondiscriminatory access to and interconnection with the transmission grid, as well as the initial responsibilities of RTOs as distinct from any underlying transmission providers within an RTO.

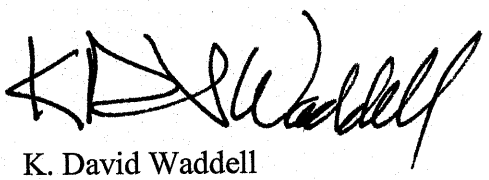
Further, the TRA suggests that, before the approval of any RTO in the Southeast, the Commission consider cost-benefit studies to determine the viability of the RTO, consult with state regulators in the region, and work with TVA as it has with GridSouth, Grid Florida, and the SeTrans sponsors of the ISA model. This would create more workable conditions for whatever RTO structure will prevail in the region.

Finally, the TRA suggests that the responses of Southeast states to these questions and the comments of Southeast states on the Commission's RTO Cost-Benefit Report to be filed by April 9, 2002, should be included in ongoing RTO and Standard Market Design dockets in order for RTO decisions to reflect input of state commissions.

Thank you for the opportunity to respond to these important questions. The TRA continues to monitor Commission actions concerning transmission issues and to consult

with TVA and both TRA-regulated and other providers of retail electric power in Tennessee. We hope that the Commission will continue to promote cooperation among federal and state regulators on these important issues. We urge the Commission to carefully consider system reliability, the ultimate effects on retail rates, and the matching of prices with costs to the extent possible in taking action on transmission issues. The TRA stands ready to participate in further activities on electricity industry issues in cooperation with the Commission and the other states.

Respectfully submitted,



K. David Waddell
Executive Secretary